DEPARTMENT OF STATE REVENUE

02-20190975.LOF

Letter of Findings: 02-20190975
Corporate Income Tax
For the Year 2018

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

The Department disagreed with out-of-state Investment Company that it met its burden of establishing that it was entitled to claim a research expense credit on the Investment Company's 2018 corporate income tax return; although there was evidence that Investment Company's claim to the credit represented qualifying research activities, the Investment Company failed to maintain contemporaneous records documenting those activities.

ISSUE

I. Indiana Corporate Income Tax - Research Expense Credit.

Authority: IC § 6-3-1-3.5(b); IC § 6-3.1-4-2(a); IC § 6-3.1-4-4; IC § 6-8.1-5-1(c); IC § 6-8.1-5-4(a); I.R.C. § 41(d); I.R.C. 41(d)(1)B)(i); I.R.C. 41(d)(1)B)(ii); I.R.C. § 41(d)(1); I.R.C. § 41(d)(1)(C); I.R.C. § 6001; *New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); Treas. Reg. § 1.41-4(d); Treas. Reg. § 1.6001-1; *Indiana Research Expense Credit*, https://www.in.gov/dor/files/rec-handbook.pdf, (last visited August 5, 2019).

Taxpayer argues the Department erred in disallowing research expense credits claimed on Taxpayer's 2018 corporate income tax return.

STATEMENT OF FACTS

Taxpayer is an out-of-state, employee-owned, private equity investment company. Taxpayer filed a 2018 "Indiana S Corporation Income Tax Return" (IT-20S). On the 2018 return, Taxpayer claimed approximately $25,000 in flow through research expense credits based on - according to Taxpayer - spending approximately $500,000 on qualifying research activities. Taxpayer based its claim on qualifying wage expenses.

Those research and development expenses were incurred at its leased space at an Indiana "innovation center" in which Taxpayer designed and built custom, automated manufacturing devices.

The Indiana Department of Revenue ("Department") reviewed the returns and disallowed the credits. That disallowance resulted in the issuance of a proposed assessment of additional corporate 2018 income tax. Taxpayer disagreed with the Department's proposed assessment and submitted a protest to that effect. A hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

The issue is whether Taxpayer has met its statutory burden of establishing that the Department's disallowance of the research and expense credits ("REC") and the subsequent issuance of additional income tax was wrong.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

For corporate income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-1-3.5(b). Indiana provides tax credits outlined in IC 6-3.1 which a taxpayer may claim to reduce its taxable

income. One of the tax credits is the "Indiana qualified research expense" tax credit under IC § 6-3.1-4-2(a), which states that, "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year." IC § 6-3.1-4-1 defines the credit. In part, this statute - in effect for the taxable years in question - provides:

> "Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

I.R.C. subsection 41(d) defines qualified research in pertinent part as follows:

> (d) Qualified research defined.-For purposes of this section-
> (1) In general. -The term "qualified research" means research-
> (A) with respect to which expenditures may be treated as expenses under section 174;
> (B) which is undertaken for the purpose of discovering information-
> (i) which is technological in nature; and
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph.

I.R.C. § 41(d)(1).

In 2016, the General Assembly clarified Indiana's application of the credit in IC § 6-3.1-4-4.

> The provisions of Section 41 of the Internal Revenue Code and the regulations promulgated in respect to those provisions are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

The federal regulation, I.R.C. § 41(d) sets out the relevant multi-part test:

I.R.C. Section 41(d) provides that qualifying research activity must meet four tests:

> (1) Permitted purpose test: The research must intend to be useful in the development of a new or improved business component – I.R.C. 41(d)(1)(B)(ii).
>
> (2) Technological in nature test: The research be technological in nature – I.R.C. 41(d)(1)B)(i).
>
> (3) Technical uncertainty test: The research must intend to eliminate uncertainty concerning the development or improvement of the business component – I.R.C. 41(d)(1)(A).
>
> (4) Process of experimentation test: The research must substantially involve a process of experimentation – I.R.C. 41(d)(1)(C).

Taxpayer explains that it is entitled to the credit based upon wage expenses incurred in developing several design/build projects.

For example, Taxpayer explained that it designed and built an automated system that would transport and stack metal ingots. Taxpayer states that it faced and overcame uncertainties in designing and constructing the system explaining as follows:

> • We were uncertain how to transfer the ingots from the molding to the cooling zone. Even as the ingot solidifies from the outside, it remains at a very high temperature;
> • We were uncertain how to synchronize all the system components because the components used different mechanisms for movement.

Taxpayer described a "process of experimentation" to develop the final device including constructing a working prototype, field testing the automated prototype, replacing originally designed equipment with a "carbon steel chain," and overcoming difficulties caused by metal debris. In addition, Taxpayer states it faced uncertainties in synchronizing and sequencing the different steps in moving and positioning the ingots.

In another example, Taxpayer explained that it designed and built an automated pallet manufacturing device that would accommodate the production of differently sized pallets. Taxpayer states that it faced and overcame uncertainties in designing and constructing the system:

> • We were uncertain how to create an automated nailing process that could account for variations in pallet designs. Pallets are made from low qualify *[sic]* wood that is often twisted or warped, so our system needed to take boards that are not flat into a known dimension and incorporate them into a design;
> • We were uncertain if we could achieve cycle times that would make nailing automation a viable option because the loading processes were still manual.

Again, Taxpayer described a "process of experimentation" in which different mechanical arms, clamps, jigs, and computer programming were tested, approved, or discarded.

As to Taxpayer's record keeping responsibility under Indiana law, the audit cited to this state's own general statutory record keeping requirement found at IC § 6-8.1-5-4(a) which provides:

> Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts and canceled checks.

Under the final regulations, a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. *See* I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.

In Taxpayer's case, it did not maintain records contemporaneous with its claimed qualifying activities. Instead, Taxpayer relied upon the recollections of various personnel garnered by means of employee interviews.

Every taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. *See* Treas. Reg. § 1.41-4(d). (*See also* IC § 6-8.1-5-4(a) which requires that taxpayers *keep* records). Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 101 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Citing *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000), the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009). See also *New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.")

The Department has specifically addressed the issue raised here by Taxpayer.

> The Internal Revenue Service and Department of Revenue have held that interviewing employees to reconstruct the activities believed to qualify (or not qualify) is insufficient in determining what employees did and whether such expenses qualify for the research credit. Without additional substantiation, research credits claimed may be adjusted or denied.

Indiana Research Expense Credit, https://www.in.gov/dor/files/rec-handbook.pdf, (last visited August 5, 2019).

Although Taxpayer has touched on and addressed each of the I.R.C. § 41(d) requirements, the Department does not agree that the after-the-fact employee interviews are sufficient to justify allowing the credits. Bearing in mind that a taxpayer claiming the credit must establish that its claim falls "clearly within the exact letter of the law" and that Taxpayer bears the statutory burden under IC § 6-8.1-5-1(c) of establishing that the proposed assessments are "wrong," the Department does not agree that the Taxpayer has demonstrated the denial of the credits was unjustified.

FINDING

Taxpayer's protest is respectfully denied.

August 20, 2019

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An html version of this document.